with each new technology upgrade. [43] That continual mix of technologies in any actual network is not taken into account in the hypothetical TELRIC network. In addition, there are significant costs of operating the business that are not a function of network investment or related to an optimal forward-looking network design. For example, ongoing cash expenses for engineering, marketing and various administrative functions continue to be incurred regardless of network design or technology.[44]

The advocates of reducing access charges to TELRIC rates argue that proxy models of TELRIC costs replicate the forward-looking "economic" costs that LECs would experience in a competitive market.[45] This is wrong as a matter of definition. Because incremental costs vary by output for industries, like the local telephone industry, that enjoy economies of scope and scale (that is, unit cost declines as output increases), the cost levels in a proxy model will depend on the assumed level of output. All of the proxy models developed by the IXCs assume the current LEC output, in which they have, according to the model proponents, over 99 percent of the market. However, by definition, a LEC would not have this amount of market share in a competitive market. As a result, a LEC will have fewer access minutes from its customers over which to spread its fixed costs, and its per unit costs will be higher. Put another way, prices in a competitive market cannot reflect the economies of scale and scope that a monopoly provider

---

[43] For example, corporations with corporate fleets of automobiles do not replace their entire fleet each time a more fuel-efficient model becomes available. Instead, they replace each car as it reaches an appropriate retirement point with a more fuel-efficient version.

[44] Approximately 50% of Bell Atlantic's and NYNEX's interstate costs are operating expenses with little relationship to investment.

[45] ***See*** Notice at ¶ 247.

could achieve. Thus, TELRIC-based rates would systematically underestimate the rates that would be charged in a competitive market.

Moreover, the difference between actual costs and forward-looking costs, using a hypothetical least-cost network, accounts for only a portion of the difference between existing access rates and forward looking costs. The advocates of reducing current access rates to TSLRIC cost levels are comparing apples and oranges. Current access rates are based on separated costs, which do not reflect the actual cost of providing interstate services. This is shown in the attached cost study, which updates a direct cost study that NYNEX provided in 1993 as part of its original USPP waiver request.[46] The study identifies NYNEX's actual 1995 costs in New York for each type of service in both state and interstate jurisdictions, based on the New York Public Service Commission's approved method for direct identification of total company costs rather than the Commission's Part 36 separations rules. The New York direct cost study demonstrates that the separations rules grossly overallocate costs to the interstate jurisdiction.[47]

Using an embedded direct cost manual approved by the New York Public Service Commission, NYNEX directly identified investments and expenses that are attributable to a particular service. Costs that support more than one service are allocated to appropriate service categories based on cost-causative characteristics. Using this procedure, only "overhead" costs,

---

46 ***See*** Exhibit 2.

47 In this study, the non-traffic sensitive costs at the loop and the switch port were assigned entirely to residence and business exchange service. However, it may be reasonable to assign a portion of these non-traffic sensitive costs to the interstate jurisdiction, to be recovered through non-usage based charges paid by end users or long distance carriers.

such as executive and planning expenses, external relations, and other administrative expenses, were not directly assigned. These costs were allocated among services in the same proportion as direct expenses.

As shown in Exhibit 2, the actual traffic sensitive cost of switched access in New York, including dedicated transport, is less than one third the costs that are assigned by the Commission's interstate rules to the usage-sensitive rates in the interstate jurisdiction. The Commission's Part 36 and 69 rules assign approximately $1.729 billion to interstate switched access. [48] This is roughly equal to the amount of money that NYNEX recovers through the end user common line charge and the usage sensitive switched access rate elements. NYNEX's current switched access rates, including the carrier common line charge, are approximately 3.5 cents per minute of use, including tandem switched transport charges. The direct cost study, however shows that the traffic sensitive costs of local switching and local transport are only $389 million. Based on the direct cost study, the traffic-sensitive costs of switched access would support a rate of approximately 1 cent per minute.[49] Looking at local switching alone, the embedded cost is approximately 0.62 cents per minute. Thus, the bulk of the LECs' current access rates represents overallocations of costs to the interstate jurisdiction. [50] Since the LECS

---

48 ***See*** Exhibit 2, p. 11.

49 The $389 million cost of switching and transport, divided by 31.5 billion interstate switched minutes of use in New York for 1995, equals 1.23 cents per minute of use. However, the $389 million includes the cost of dedicated transport, which should be excluded from a usage-based charge for switched access. Therefore, the actual total company cost of switched access, including tandem switched transport, is approximately 1 cent per minute of use.

50 In particular, the TIC represents a large portion of the overallocation of costs to the interstate jurisdiction. Exhibit 2, p. 12 shows that the Commission's Part 36 and Part 69 rules allocate $515 million in costs to local transport in New York, while the direct cost study shows

are prohibited by law from recovering, in their state rates, costs that the Commission has assigned to the interstate jurisdiction, it would be confiscatory for the Commission to prevent the LECs from recovering these costs in their interstate rates.

Finally, as a practical matter, prescription based on TELRIC or TSLRIC studies would significantly handicap the ability of the LEC industry to make future investments. Because these studies are based on forward-looking investments, they are likely to prevent the LECs from continuing to recover the costs of their existing investments. The LECs depend on recovery of past investments (as well as other current revenues) to provide the funding for future investments. For example, in 1995, NYNEX invested $1.4 billion in its network in New York. [51] That money did not come from creditors – like most LECs, NYNEX obtains relatively little in capital through new borrowings. Most of the new stock that NYNEX issues is in the form of compensation to its employees. Almost all of the $1.4 billion was obtained through internally generated funds. This internal cash flow is realized primarily because of the level of depreciation expense the company has been allowed to include in its rates.[52] If the Commission implicitly disallowed that depreciation or otherwise reduced revenues by setting rates on the basis of a proxy model, NYNEX would not have the funds to build the new, forward looking network upon which the model is based. Reductions in access charges would reduce the amounts that the LECs would have available to meet consumer demand and to provide the unbundled network elements upon which their competitors will depend.

---

that the cost of local transport is only $192 million. The difference -- $323 million -- is recovered through the TIC.

51 ***See*** New York Telephone Company 1995 Form 10-K, p. 28.

52 ***See id.***. (1995 depreciation expense equals $1.394 billion).

B. There Is No Basis For "Reinitializing" Price Cap Indices Based On Earnings Or Rate Of Return Regulation. (¶¶ 228-230)

The Commission asks whether it should "reinitialize" price cap indices ("PCIs") to produce rates designed to yield the most recent benchmark cost of capital of 11.25%, or a newly calculated cost of capital.[53] According to the Commission, such reinitialization might be reasonable to balance ratepayer and stockholder interests if the price cap LECs' cost of capital is now less than 11.25%.[54]

Any such reinitialization would be a step backwards to the discredited rate of return system of regulation, and would be wholly contrary to the policies of incentive regulation. As the Commission itself recognizes, "reinitializing indices based on earnings could have a negative effect on the productivity incentives of the price cap plan."[55] Moreover, the Commission has repeatedly made it clear that price cap/incentive regulation is superior to rate of return or earnings-based regulation, which dampens efficiency incentives.[56] The Commission should adhere to this wise policy and not retreat to a rate of return regime through some prescriptive "reinitialization" of rates.

The Commission has also declined to adopt proposals to set the X-Factor (productivity offset) in the LEC price cap plan so as to reprice access services at a targeted rate of return (such as 11.25%). The Commission found that such proposals may not create adequate incentives for

---

53 Notice, ¶ 228.

54 ***Id.***

55 Notice, ¶ 230

56 ***See*** Section I, supra.

increasing productivity.[57] Further, the Commission has found that the sharing mechanism in the LEC price cap plan -- a vestige of rate of return regulation -- "blunts the efficiency incentives created by the price cap formula by diminishing the profits that LECs can achieve by reducing unit costs."[58] The Commission observed that a "rate-of-return backstop" (sharing mechanism) is inimical to "consumer welfare and the health of the national economy" and entails "added complexities and regulatory burdens."[59] Accordingly, the Commission has established a long-term goal of eliminating sharing.[60]

In light of these considerations, the Commission in *the Price Cap Review Order* appropriately rejected proposals for one-time rate reductions based on changes in interest rates, changes in the overall cost of capital or based on LEC earnings levels.[61]

Reinitializing price cap rates based upon a represcribed rate of return would be improper for several additional reasons. First, the Commission inquiry into whether to start a rate of return represcription case for LECs not subject to price caps was triggered solely on interest rate moves.[62] There is no basis to presume any reduction in the cost of capital for price cap LECs. Many factors -- of which interest rates are just one -- affect the cost of capital and appropriate rate of return. The fundamental changes in the telecommunications industry unleashed by the

---

57 Notice at n.295; ***Price Cap Performance Review for Local Exchange Carriers***, 10 FCC Rcd 13659, 13672 (1995) ("Price Cap Fourth Further Notice").

58 ***Id.*** at 13677.

59 Price Cap Review Order at 9045-9046.

60 ***Id.*** at 9047-9048.

61 ***Id.*** at 9069, 9073.

62 Notice, ¶ 228.

Act including vigorous and growing competition, and regulatory risk and uncertainty translate into increased business risk and required rate of return. The continued need to spur investment in telecommunications infrastructure also tends to increase the required rate of return. A further proceeding to fully examine all these factors would be needed to determine the price cap LECs' cost of capital and reasonable rate of return. However, such a proceeding would be administratively burdensome and inconsistent with ongoing price cap regulation.

Second, reinitializing PCIs to reflect a new rate of return prescription would be an unwarranted exogenous change. Such action would be fundamentally different from the adjustment ordered by the Commission at the inception of price cap regulation (1991) to effect the prescribed 11.25% rate of return.[63] The Commission at that time had just completed a full rate of return represcription proceeding while LECs were still under rate of return regulation, and the Commission wanted to initialize price cap rates using recent rate of return regulation-based rates, including that new rate of return.[64] However, price cap LECs have now been under price cap regulation for more than six years, so that it is unnecessary to make an exogenous rate of return adjustment to initiate price cap rates; the "one-time" adjustment was already made one-

---

[63] LEC Price Cap Order at 6814, 6816. ***See also Policy and Rules Concerning Rates for Dominant Carriers***, Supplemental Notice, 5 FCC Rcd 2176, 2280-2281 (1990) ("Supplemental Notice").

[64] Supplemental Notice at 2279-2280: ***See also*** LEC Price Cap Order at 6814.

time, on January 1, 1991.[65] Such a change midstream in price cap regulation would amount to a completely improper reimposition of rate of return regulation.[66]

C. Any Cost Recovery Must Address the Depreciation Deficiency. (¶¶ 250-255, 259-270)

In addition to current rates, the Commission must also provide the opportunity for full recovery of embedded investment in plant and equipment.[67] The regulatory depreciation which was the basis for past recovery for all of Bell Atlantic's and NYNEX's plant and equipment has been controlled by the Commission, as was required under the 1934 Communications Act.[68] As a result of past regulatory limits, the current amount of embedded investment remaining to be recovered far exceeds its economic value. Absent special recognition of these unrecovered costs, the company will have no opportunity to fully recover that investment.

In the monopoly environment envisioned by the 1934 Act, there was little concern about under-depreciation. Both regulator and regulated company could have confidence that the depreciation would eventually be fully recovered.

That is not true today. Regardless of the current level of competition, local carriers face a complete opening of their market, both from new facilities-based competitors, and from

---

65 In this regard, "reinitialization" is really a contradiction in terms.

66 Moreover, changes in cost of capital are already reflected in changes in both productivity and inflation. Any effort to adjust the price cap formula based on an alleged change in cost of capital would inevitably double count those changes.

67 ***See Democratic Cent. Comm. of D.C. v. Washington Metro. Area Transit Comm'n***, 485 F.2d 786, 808 (D.C. Cir. 1973) ("Ratepayers bear the expense of depreciation, including obsolescense and depletion, on operating utility assets through expense allowances to the utilities they patronize.") (footnotes omitted).

68 ***Simplification of the Depreciation Prescription Process***, 8 FCC Rcd 8025, 8030 (1993).

competitors relying on the resale and unbundling provisions of the Act.[69] There can be no debate that the days of monopoly service are over. To suggest that recovery be further delayed because the local access market is not yet fully competitive is to deny any opportunity to recover. As Dr. Rohlfs and his colleagues explain, "regulators need to give LECs the opportunity to recover capital that exceeds economic value before markets become effectively competitive."[70] If the regulator waits, prices are completely checked by market forces, and any recovery attempt would be too late.

Since 1934, the Commission's depreciation policy has had the effect of significantly overstating the economic value of plant. The policy was intended to allocate capital costs in a straight line manner over their remaining life.[71] Service life was defined as the time from when plant was placed in service until it was retired. As Dr. Rohlfs demonstrates, this approach does not match the loss in economic value because the decline in economic value may occur more quickly than a straight line depreciation schedule would project, and the time from placement in service until accounting retirement does not necessarily match economic life.

---

69 For example, AT&T, MCI, Sprint, Cable and Wireless, MFS, TCG and others have already announced their entry into the local telephone market. *USA Today* reported that AT&T has plans to enter the local market in Connecticut during the second week of February (S. Rosebush, "AT&T to Begin Local Phone War in Conn.," 1A, Jan. 22, 1997). *The Baltimore Sun* reports that MCI will spend at least $700 million in 1997 "to expand its push into the U.S. local phone market." ("MCI Sets 1997 Spending of at Least $700 Million," C2, Jan. 17, 1997).

70 J. Rohlfs, "The Depreciation Shortfall," Strategic Policy Research, at 4, attached to USTA Comments ("Depreciation Shortfall").

71 ***Amendment of Part 31 So As to Permit Depreciable Property to Be Placed in Groups Comprised of Units with Expected Equal Life for Depreciation Under the Straight-Line Method***, 83 F.C.C.2d 267 (1980).

The same competitive phenomena that makes recovery more and more difficult drives shorter economic lives of plant and equipment. The increasingly competitive market for telecommunications equipment and technologies, and the changes in technology that spur even greater competition among service providers, also make obsolete the plant that might otherwise have a longer remaining useful life.[72] A fully competitive market will limit recovery of existing investment to its current economic value. Current Commission-mandated depreciation methods do not reflect the loss in economic value. If LECs cannot recover current under depreciation due to regulatory policies, and are not assured of future depreciation recovery at a rate commensurate with the true economic lives of plant and equipment, then the incentive to continue to invest in maintaining and improving the network will be severely undermined.

The Commission recognizes that under-depreciation is a significant issue in this proceeding.[73] Moreover, the Commission has previously used a special reserve deficiency amortization to recover some depreciation deficiencies.[74] This effort by the Commission was not intended to adjust net investment levels to economic value, only to adjust for certain past under recovery. From that view, it was inadequate. However it does provide a precedent as to how to measure the inadequacy of past depreciation allocations using current assumptions. Based on the conservative theoretical reserve methodology required by the Commission staff[75]

---

72 Depreciation Shortfall at 3; ***see also*** NYNEX Depreciation Rate Study (Feb. 27, 1996), describing impact of competition on depreciation parameters.

73 ***See*** Notice at ¶¶ 250-254, 259.

74 ***Amortization of Depreciation Reserve Imbalances of Local Exchange Carriers***, 3 FCC Rcd 984 (1988).

75 Federal Communications Commission, ***Depreciation Study Guide***, 1996, Section C-1.

and using the companies' estimates of life and salvage which underlie their 1996 financial reports to investors, Bell Atlantic's has estimated that its reserve deficiency is over $2.6 billion, $740 million of which is interstate costs; NYNEX's deficiency is $668 million, of which $158 million is interstate.[76]

These numbers represent a reasonable calculation of the minimum level of under depreciated costs. They are based on the assumption that economic value declines in a straight line over time, when in fact the largest decline occurs early in the life of an asset. As such, they are a minimal estimate of the amount of "catch up" recovery needed to bring the companies' unrecovered investment closer to its economic value under the 1996 Act.

Further evidence of the overstatement of economic value can be seen by examining companies whose depreciation rates are not subject to the same regulatory process as those of the LECs. The current regulated depreciation levels of the LECs are far lower than those of nonregulated companies with comparable plant.[77] Indeed, AT&T depreciates its plant 53% faster than the LECs --a far greater difference than can be explained by the difference in its mix of plant.[78] Even the Commission's own proxy prices for unbundled elements assume a replacement rate that is far higher than is used in Bell Atlantic or NYNEX's calculation of the reserve deficiency.[79]

---

[76] Attached as Exhibit 3 is a workpaper that shows the calculation of these deficiencies.

[77] For example, MFS depreciates its plant 32 percent faster than the LECs. Depreciation Shortfall at 17.

[78] ***Id.*** at 18.

[79] ***Id.*** at 22-23.

Given the LECs' growing inability to recover these reserve deficiencies, the Commission must act quickly to resolve the problem by creating a separate competitively neutral pricing mechanism for the LECs to recover these costs. That mechanism should permit amortization of these deficiencies over a five year period. Any such amortization would have to be in addition to recovery of the existing Part 36 costs, which are based on the current regulatory depreciation levels.

Once the Commission has provided a competitively neutral mechanism to address this existing shortfall in economic value, it could also avoid future problems by providing LECs with the flexibility to calculate future depreciation at market levels. Both NYNEX and Bell Atlantic expect to increase their underlying depreciation rates above the amortization if permitted to use their best estimates of life and salvage. Such a market-based approach to depreciation is consistent with other policies necessary to implement true access reform.

IV. The Commission Should Adjust Access Rate Structures Within the Price Cap Framework. (¶¶ 57-138, 243-246, 271-281)

As has been widely acknowledged, historically "access pricing has not been based strictly on cost or the way costs are incurred but has also reflected social objectives resulting in numerous rate level deviations from strict cost-based pricing."[80] The Notice correctly recognizes that it is perfectly consistent with a market-based approach to access reform for the Commission to make changes to the access rate structure that will allow recovery on a more cost causative basis.

---

80 "Federal Perspectives on Access Charge Reform," A Staff Analysis, at 4 (Apr. 30, 1993).

The Commission, however, does not have complete flexibility. To the extent that the level of certain access rates reflects an allocation of costs to the interstate jurisdiction based on the Commission's separations rules, as set forth above, the Commission cannot readjust rates in any way that would prevent the LECs from having a reasonable opportunity to recover these costs. While the Commission may convene a Joint Board to reexamine separations policy, it lacks the legal authority to assign costs unilaterally to the intrastate jurisdiction.[81] Moreover, while separations reform could redetermine the jurisdiction in which these costs are recovered, it cannot put into question whether these costs are recovered.

A. Common Line Charges (¶¶ 57-70, 243-244)

The Common Line charges are particularly impacted by the policy underlying the current separations rules. As a number of former federal and state regulatory officials detail in their affidavit, the history of allocating costs to the interstate jurisdiction reflects a policy judgment on the part of states and the FCC.[82] As Dr. Robert Crandall explains in the attached affidavit, the Commission may restore greater economic rationality to the recovery of these costs by recognizing that these non-traffic sensitive costs should be recovered through flat rate charges.[83]

---

81 ***Smith v. Illinois Bell Tel. Co.***, 282 U.S. 133 (1930); ***Southern Pacific Communications Co. v. AT&T***, 556 F.Supp 825, 998 (1983) ("...the Communications Act of 1934 gives the States, not the FCC, jurisdiction over intrastate telecommunications services"). ***See also Implementation of Infrastructure Provisions in the Telecommunications Act of 1996***, CC Docket No. 96-237, Notice of Proposed Rulemaking, ¶ 21 (rel. Nov. 22, 1996) (the Commission noted that changes to Part 36 of the rules would "need to be addressed by a Federal-State Joint Board").

82 Fischer Affidavit at 14-21.

83 Crandall Affidavit at ¶¶ 7-8. The Commission acknowledges that these costs are non-traffic sensitive and, in the Price Cap Review Order, deferred consideration of the common line issues to another proceeding. ***See*** Price Cap Review Order at 9079-9080.

Because these costs are ultimately caused by the end-user, placing these costs on the end-user is an appropriate mechanism for such recovery. The Universal Service Joint Board, however, rejected the idea of a general increase in the Subscriber Line Charge ("SLC") and the Commission does not propose such an increase here.[84]

The Commission does propose raising the cap for the SLC on multi-line business customers and for multi-line residences. For business lines, raising the cap to cost is an appropriate step, but a small one. Most lines are already at cost within the existing cap. For example, in Bell Atlantic's region, only in West Virginia would there be any change in recovery.

The proposal to raise the SLC on second lines raises a number of concerns. First, neither NYNEX nor Bell Atlantic have comprehensive historical records of second lines, so a complete identification of second lines would be very difficult except on a going forward basis. Second, to the extent the Commission intends to differentiate second lines to families from first lines to new tenants in shared address dwellings, the change in rates requires customer self-reporting and calls for information collection and verification by the LECs that goes far beyond customer information collected today. The Commission should not place the LECs in the position of policing classification based on who is using a specific line.[85] Third, the added second line charge puts LECs at a competitive disadvantage to competitors by conflicting with customers' perceptions that increasing the volume of a purchase should lower -- not raise -- the cost of each

---

[84] Recommended Decision at ¶ 11.

[85] The problem is even more acute in the identification of lines to second homes. Absent a self-reporting policed by the LECs, there is no way to tell whether a customer service order relates to a second residence. Moreover, in many instances, a second home may not even be served by the same carrier as the initial residence.

item. Carriers already are targeting the market for second lines, as illustrated by the attached Teleport advertisement (Exhibit 4). A rule requiring LEC second lines to be priced higher than first lines would make it difficult for the LECs to respond to competition. Thus, to the extent the Commission adopts this proposal, it should allow it to be a pricing option for the LECs, with no loss of Carrier Common Line (CCL) recovery for those carriers that are unable or choose not to take the option.

Similarly, deaveraging the SLC may be an appropriate option for some companies. Giving companies the option to deaverage the SLC within existing caps would allow companies to base their decision on market forces. Carriers may wish to tie deaveraging the SLC to a more broadly based geographic deaveraging of rates, and the Commission should allow such flexibility.

SLC deaveraging, however, should not be mandated. Average SLC rates are a simplified recovery mechanism that meets customers' expectations. Moreover, Section 254(e) of the Act does not require deaveraged rates. The SLC recovers actual costs and is not a specific universal support mechanism -- the only subject of Section 254(e). Regardless, rates cannot be considered subsidized just because they are averaged. Any rate that is not on a customer specific basis involves some sort of average. Geographic deaveraging only narrows the scope of the area to be averaged.

The Commission also raises the issue of how to charge a SLC for ISDN lines.[86] Charging a single SLC for each network interface (1 SLC for every BRI; 1 for every PRI) will

---

[86] Notice, ¶ 70.

serve the goals of not discouraging use of this technology and allowing the cost causers to pay a reasonable cost-based charge.[87]

The remaining common line cost assigned to the interstate jurisdiction is currently paid by interexchange carriers on a per minute basis. The Joint Board's recommendation to remove NECA long term support payments from the carrier common line charge, and to permit rural LECs to recover those payments through universal service support is appropriate.[88] Moving the remaining carrier common line charges to recovery on the basis of presubscribed lines would allow these non-traffic sensitive costs to be recovered in a more economically rational manner, and would be relatively simple to administer. Moreover, as the Commission has recognized,[89] such recovery is consistent with how these costs are allocated through the Part 36 separations process. In addition, moving from a per minute to a per line rate will correct the imbalance between high volume end users, who in effect overpay their portion of loop costs, and low usage customers, whose access usage may not cover the allocation of loop costs.

Interexchange carriers could adopt a variety of pricing plans to recover these costs, such as flat monthly charges, minimum monthly usage charges, or other pricing plans. Thus, end users will have competitive alternatives in choosing pricing plans that recover these costs. Because long distance carriers would have the option of passing these fixed charges directly to their presubscribed customers, their per-minute rates need not be placed at a competitive

---

87 ***See End User Common Line Charges***, CC Docket No 95-72, NYNEX Reply Comments at 6. (filed July 14, 1995)

88 ***See*** Recommended Decision at ¶¶ 753, 767-768; Notice at ¶ 243.

89 Price Cap Review Order at 9079.

disadvantage with respect to dial-around competitors. Any end-user that failed to presubscribe to a long distance carrier should be billed for the charge directly by the LEC.

Moving the CCL to a per-line charge will also require adjustment of the price cap formula, since the existing formula assumes the ability of the LECs to apply usage based rates to recover network costs that are largely nontraffic sensitive. The existing "g/2" adjustment removes from LEC rates one half of the growth in CCL that results from any increase in minutes of use. If the Commission moves to a per-line charge, LECs would give up all the per-minute growth. Clearly, once the CCL is restructured, the g/2 adjustment would have no continued purpose and should be eliminated.

B. Transport Interconnection Charge (¶¶ 96-122)

The court's mandate to the Commission in the ***CompTel*** decision is to justify its disposition of the Transport Interconnection Charge (TIC).[90] There is no mandate to eliminate or even reduce the charge. The court in ***CompTel*** recognized that the TIC recovers actual costs allocated to the interstate jurisdiction, including "80 percent of the allotted cost of tandem switching."[91] Indeed, the focus of the Court's opinion is not the amount of the charge, but rather the absence of justification as to how and on whom the charge is to be imposed.

To apply charges on a more cost-causative basis, the Commission should redistribute to specific access rate elements that portion of the TIC that can be identified as misassigned

---

90 ***Competitive Telecommunications Ass'n v. FCC***, 87 F.3d 522, 531-32 (D.C. Cir. 1996) ("CompTel"). The ***CompTel*** Court also required that the Commission address the level of overhead costs included in the tandem switching rate. ***CompTel*** at 533. As shown in Exhibit 5, for both Bell Atlantic and NYNEX the overhead loading factor associated with tandem switching falls within the range of loadings used for special access DS1 and DS3 services.

91 ***CompTel*** at 532.

transport costs.[92] These include existing rate elements as well as elements to recover previously unspecified costs which, because of the TIC establishment process, ended up in the TIC. While the price cap indices for the existing rate elements must be adjusted upward to accommodate potential recovery of these costs, it is likely that the transferred costs will not be fully recovered. In many instances market pressure will force LECs to forego this revenue. Nevertheless, in order to allow the LECs the opportunity to recover their actual costs, the Commission must adjust the price cap indices based on the current actual cost recovery levels for these elements that are embedded in the TIC, and not some forward looking cost proxy that leaves portions of the LECs' actual costs still in the TIC -- which would perpetuate the uneconomic recovery of costs from parties other than the actual cost causers.

The remaining TIC includes costs that are allocated to the interstate jurisdiction through Part 36. At its creation in the Commission's Local Transport Restructure ("LTR") proceeding, the TIC represented the difference between the transport revenues generated by the historical per minute of use charges and the revenues generated when switched access local transport services were repriced using Special Access charges for comparable facilities. This revenue differential consists of actual costs that were assigned to the interstate jurisdiction, but were no longer associated with a particular rate element.[93] As is shown in Exhibit , NYNEX's current transport costs, based on interstate separations, are over twice the directly identified costs of providing transport service. The difference is represented by the TIC. Unless and until there is a

---

92 In an attachment to its comments, USTA has specifically identified where such adjustments are to be made, and how to quantify them.

93 ***Transport Rate Structure and Pricing***, Report and Order, 7 FCC Rcd 7006, 7038 (1992) and First Memorandum Opinion and Order on Reconsideration, 8 FCC Rcd 5370, 5379 (1993).

reassignment of costs away from the interstate jurisdiction, these costs must continue to be recovered through interstate charges.

There are two alternatives that the Commission could employ to deal with the residual TIC. One option would be to utilize a mechanism that would effectively distribute this amount to the IXCs for recovery. This method would recognize the need to recover these costs from customers in the interstate jurisdiction pending separations changes, based on their proportionate shares of the LEC interstate access minutes. For price cap purposes, the TIC residual should be in the Transport Category, and the LEC should be allowed to target price cap reductions to this element.

An alternative would be to allow the LECs to recover the residual TIC amount on a per presubscribed line basis to the IXCs. This per line rate element would also be within the Transport Category, and the LEC could target price cap reductions to this element.

Either alternative must be recognized as interim. Because the TIC residual represents overallocations to the interstate jurisdiction, the issue will be fully resolved only when the separations issues are addressed. Pending separations changes, these temporary mechanisms would be easy to administer, would not unduly burden the IXCs, and would enable the LEC to reduce the size of the issue through the targeting of price cap reductions.

C. Switching (¶¶ 71-79)

For all interstate switching charges (local and tandem), the Commission should add flexibility to the rate structure. Even four years ago, the Commission's staff recognized that as "the access market becomes more competitive, affording IXCs more choice in access providers, a

rigid approach to access service rate structure may no longer be necessary to ensure that no discrimination occurs among IXCs. Instead, such an approach may have the unintended and undesirable effect of preventing full, fair, and effective competition."[94] There can be no dispute that competition has increased dramatically in the last four years. Moreover, interexchange carriers have gained a competitive alternative through the use of unbundled elements of the LECs' own network. As a result, there is no longer any reason for a single rate structure to be imposed uniformly on all companies.

For those companies that choose to recover some or all non-traffic sensitive costs separately from the traffic sensitive costs, they should be allowed to do so. In order to avoid an undue number of rate elements, companies should have the option of retaining the existing per-minute structure for local switching, without separately quantifying non-traffic sensitive costs or recovering them on a flat-rate basis. The administrative burden and cost of creating and maintaining new rate elements may, for many companies, outweigh the benefit of constructing theoretically correct rate elements.

In addition, some types of costs may not fit neatly into such cost categorization. For example, certain charges may be incurred on a per-call attempt basis and should best be recovered through a call set-up charge. Such charges would be incurred regardless of call completion or duration. Again, the need for and appropriateness of such a charge should be left to the individual company based on its evaluation of the market.

---

94 Federal Perspectives on Access Charge Reform at 33.

Similarly, the Commission should provide companies with the option to introduce new pricing elements and charges (on a revenue neutral basis) that would allow recovery in different ways. For example, the Commission proposes varying charges on a peak/off-peak basis. Such a change should not be mandatory, however. Because companies must have the capacity to handle peak periods regardless of the time of day, very few costs truly vary with the time of day. As a result, peak/off peak rates could provide false market signals.

D. SS7 (¶¶ 123-138)

Similar to switching, LECs should have the flexibility to adopt the appropriate rate structure for SS7 signaling services to meet their market situation. For Bell Atlantic and NYNEX, the current flat rate and distance sensitive charge reflect their current ability to track the associated costs. We currently do not have the ability to track SS7 usage in a manner that would allow us to create more complex usage sensitive rate elements such as those allowed for Ameritech. Many other LECs appear to be in the same situation. A flexible rate that permits, but does not require, an SS7 signaling charge is therefore essential.

If the Commission should nevertheless mandate such a separate rate element, the Commission must permit a LEC to recover all of the direct costs that it will incur to be able to bill that rate element.[95]

E. Transport (¶¶ 80-95)

The Commission tentatively concluded that the transport rate structure rules should continue to mandate flat-rated charges for entrance facilities and direct-trunked transport

---

[95] Bell Atlantic estimates that its direct costs to create and support a separate rate element for SS7 signaling would range from approximately $15 to $40 million.

services.[96] These services should be provided on a flat-rate basis because the facilities used to provide these services are dedicated to individual customers. The Commission should eliminate an IXC's interim ability to select a usage-sensitive option for its tandem switched transport from a tandem office to the IXC's serving wire center. Instead, IXCs using tandem-switched transport should be required to pay for a dedicated link between the serving wire center and the access tandem as dedicated trunk transport.[97] Under a rational pricing structure, customers would select the appropriate sized facility to meet their capacity needs. Under the current structure that has not happened,[98] and LECs have been forced to provision the service less efficiently than they could if it were priced on a more economically rational basis. LECs have been required to maintain trunk capacity that is underutilized, which exhausts tandem switch capacity, and to route traffic through tandem switches that could be used for other purposes. If all IXCs were required to purchase these services as direct trunked transport on a flat-rate basis, they would have the incentive to size their requirements based on their actual needs, and they would select the most economically efficient arrangements to meet those needs.

F. Terminating Access (¶¶ 271-281)

The Commission suggests that regardless of the level of competition in a market, terminating access may represent a bottleneck service.[99] NYNEX and Bell Atlantic are unaware

---

96 Notice, ¶ 86.

97 LECs will retain traffic sensitive charges for the leg between the tandem and the end office.

98 In fact, no Bell Atlantic or NYNEX customer has taken the option to use a dedicated facility between a tandem switch and a serving wire center under the current rate structure.

99 Notice, ¶ 271.

of any empirical evidence that suggests that the price of terminating access is priced above market levels and has acted as a bottleneck service. The availability of alternative methods of call termination and increased competition will provide sufficient pricing discipline.

Nevertheless, if the Commission determines that there is a potential problem, it cannot impose rate solutions that do not offer the opportunity to recover all of a company's costs. Moreover, the Commission is correct that to the extent a problem does exist, it is common to all providers of terminating access, and not just incumbent LECs. Thus, any mandate for terminating access rates must apply to all providers, including carriers otherwise classified as nondominant.

Rather than extend regulatory control of the market and impose rigid price requirements, the Commission could simply add a safeguard, by requiring that terminating access be priced at the same level as originating. This still imposes a regulatory mandate to "solve" what appears to be a problem of economic theory rather than market fact. But such a solution would at least allow market forces, rather than regulatory fiat, to control the price level.

V. The Commission Should Adopt a Two-Phased Market-Based Approach to Pricing Flexibility. (¶¶ 14-16, 30, 149-217)

The Notice identifies a number of important reforms that would allow LECs to create pricing options that better meet customers' needs. These reforms also allow LECs to address their own competitive concerns by offering pricing options comparable to those offered by their competition. Such flexibility would facilitate pricing reductions based on actual market conditions, rather than regulatory assumptions.

As proposed in the Notice, however, requirements that the LECs must meet before obtaining the Phase 1 relief could needlessly delay the implementation of the proposed reforms. These requirements all relate to the opening of a local market to competition. While similar to portions of the section 271 checklist, an independent requirement could engender needless rounds of regulatory debate and delay, thereby allowing competitors to gain a market advantage by gaming the regulatory process. Because the same market-opening criteria will be evaluated by the states prior to approval of an interconnection agreement, Bell Atlantic and NYNEX propose that the existence of a state-approved agreement should replace all of the proposed Phase 1 requirements. Such a standard relies on the local regulator -- the body in the best position to evaluate local conditions.[100]

Once a LEC has opened its market and met the Phase 1 trigger of a state approved interconnection agreement, it should be afforded the reforms noted in the Commission's Phase 1. The LEC will have been recognized as having opened its markets and should be able to deaverage access rates, introduce volume and term plans, respond to RFPs and enter into contract arrangements, as well as introduce new services outside of price cap regulation. Indeed, because the market is open to entry, strong consideration should also be given to providing the LEC with the ability to price by customer class (similar to the NYNEX USPP), and with a streamlined price cap basket structure.

---

[100] Such reliance on local regulatory bodies also avoid jurisdictional concerns that arise if the Commission were to use pricing flexibility controls as a lever to reassert federal authority over state competition issues. ***See Iowa Utilities Bd. v. FCC***, No. 96-3321, 1996 WL 589204 (8th Cir. Oct. 15, 1996).

In Phase 2, once a carrier has entered the market for which the barriers were removed in Phase 1, the rate structure rules for transport and switching can be eliminated, and the LECs released from price regulation altogether.

As the Commission has recognized, price cap regulation is intended to "facilitate the transition to competition," but should be removed once competition renders price controls unnecessary.[101]

A. Much of Phase 2 Reform Should Be Available in Phase 1 (¶¶ 14-16, 161-217)

In its previous comments in Docket 94-1, NYNEX proposed a multi-phased market - based approach to access charge reform, similar to the proposal outlined in the Notice.[102] There would have been a base-line level of reforms (Phase I-A), followed by two phases of increased pricing flexibility that would be triggered by the removal of barriers to entry (Phase I-B) and by the presence of competitive providers of local telephone service (Phase I-C). In Phases II and III, services would be deregulated when they were shown to be subject to effective competition.

This proposal was based on the assumption that competition in the local telephone market would be primarily facilities-based. Since it takes time for new entrants to deploy facilities, the NYNEX proposal recognized two distinct phases during the start of local competition. However, the Commission's decision to allow competitors to purchase unbundled network elements from the incumbent LEC on the basis of unsupported cost will allow new entrants to provide service throughout the area served by the LEC without building their own facilities and without being

---

101 Price Cap Review Order at 8965 (emphasis added).

102 ***See*** NYNEX Comments, CC Dkt. No. 94-1 (filed Dec. 11, 1995) at pp. 14-34.